VZCZCXYZ0000
OO RUEHWEB

DE RUEHSF #0059/01 0411119
ZNY CCCCC ZZH
O 101119Z FEB 09
FM AMEMBASSY SOFIA
TO RUEHC/SECSTATE WASHDC IMMEDIATE 5760
INFO RHEHAAA/NATIONAL SECURITY COUNCIL WASHINGTON DC PRIORITY
RUEAIIA/CIA WASHINGTON DC PRIORITY
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC PRIORITY
RHEBAAA/DEPT OF ENERGY WASHINGTON DC PRIORITY
RUEATRS/DEPT OF TREASURY WASHINGTON DC PRIORITY

C O N F I D E N T I A L SOFIA 000059

SIPDIS

E.O. 12958: DECL: 02/04/2019
TAGS: ECON PGOV PREL BU
SUBJECT: BULGARIAN LEADERSHIP SHRUGS OFF CALLS FOR IMF
PRECAUTIONARY AGREEMENT

REF: 08 SOFIA 0731

Classified By: Ambassador Nancy McEldowney for reasons 1.4 (b) and(d).

¶1. (C) Summary: The ruling Socialists and the Bulgarian National Bank continue to brush aside suggestions that Bulgaria pursue a precautionary agreement with the IMF to protect the currency board and prevent a devaluation of the lev. They argue that the long-standing policy of fiscal conservatism provides sufficient buffers to allow the economy to ride out the global financial crisis. The 2009 budget projects a three percent surplus while offering a stimulus plan heavy on public projects designed to bolster employment and household income. But critics argue that the government's growth projections are unrealistically high. The government itself warns that it may be forced to revise the budget and reduce the surplus in June if revenues miss the mark. The IMF itself has been silent on the issue of a precautionary agreement, but continues to urge realism in growth forecasts, reining in spending, and maintaining large surpluses. End Summary.

¶2. (C) On February 3, Bulgaria's junior coalition partner NMS urged Bulgaria to sign a precautionary agreement with the IMF to avoid a potential devaluation of the lev. Former Finance Minister and deputy leader of NMS Milen Velchev said the support such an agreement would provide to the currency board would be worth any political hits the ruling coalition might take for signing such an agreement. The same day, head of Bulgaria's Deposit Insurance Fund Bisser Manolov told us privately he saw no way for Bulgaria to avoid a future IMF agreement, due to rising concerns over a persistent current account deficit (24 percent in 2008) and slowly deteriorating bank balance sheets. The Government and the Bulgarian National Bank disagree. They say the banking sector is strong and years of fiscal conservatism have left the country with ample reserves (12.1 billion euros in foreign exchange reserves including 3.9 billion euros in fiscal reserves.) They believe a precautionary agreement is not only unnecessary, but potentially harmful, as it would undermine investor confidence at a time when Bulgaria is fighting to attract FDI.

2009 BUDGET: BALANCING STIMULUS AND SURPLUS

¶3. (SBU) The government's 2009 budget continues the tradition of fiscal conservatism, targeting a surplus of three percent of GDP. To mitigate risk of revenue shortfall in the face of an uncertain economic climate, the budget mandates that all government institutions restrict spending to 90 percent of the 2009 budgeted amount. The remaining 10 percent will be released when the revenue situation is clearer. The election year budget also features increases in

pensions and a large stimulus package (USD 3.7 billion or seven percent of GDP) to kick-start economic activity. The plan envisions large public projects in the telecom, railway and water sectors and money for export-oriented sectors including textiles, machine building and chemicals. The government investment program is designed to soften the effects of a slowdown in FDI, which declined by 11 percent in 2008 and is projected to decline 12 percent further in 2009. The ruling Socialists say their economic plan is flexible: if growth is lower than expected it is prepared to tap into fiscal reserves to expand public investment. If revenues miss the mark, the budget will be revised in June and the surplus may be reduced.

¶4. (SBU) Critics of the budget, including the center-right opposition, right-leaning economic analysts and business groups dispute the growth projections (4.7 percent of GDP) on which the budget is based. They argue that even under the most optimistic scenario, 2009 growth will reach just two percent. The IMF agrees. Key industries, including tourism and construction are already seeing dramatic downturns. In addition, the economy has been hit by two external crisis that have had a profound impact on the business sector in the first month of 2009 alone. For two weeks in January the country suffered a complete gas cut-off as a result of the Russia-Ukraine gas dispute. Initial direct losses incurred by Bulgarian companies are estimated at 456 million leva (304 million USD). In addition, protests by Greek farmers have blocked the Bulgarian-Greece border sporadically since January 20, resulting losses to Bulgarian exporters and transport companies.

THE BANKING SECTOR: HOLDING STRONG, BUT LESS VIBRANT
-- -------

¶5. (C) The mostly foreign-owned banking sector continues to post profits, but there is growing concern that the reliance on parent banks for new lending makes the system increasingly vulnerable. With parent bank infusions drying up, banks are engaging in "deposit combat," with interest rates on lev-denominated deposits over nine percent at some banks. At 14.86 percent, capital adequacy is still well above EU averages and the loan to deposit ratio is 127 percent. The percentage of non-performing loans has risen slightly since November, but still remains low at 2.41 percent. This percentage is likely to rise further as households and companies face decreased refinancing opportunities and rising interest rates. To increase liquidity in the system and reinvigorate interbank lending, the BNB lowered reserve requirements from 12 to 10 percent in December. Western bankers here privately tell us that troubling signs are growing; having turned ultra-cautious in the aftermath of world financial illiquidity, they are casting very critical eyes on the overall banking sector and economy as FDI, remittances, and exports all slow.

WHAT SAYS THE IMF?

¶6. (SBU) The IMF has remained silent on the debate over the need for a precautionary agreement. After its December Article IV consultations, the fund expressed concern over a sharp widening of external and internal imbalances, including the persistent current account deficit. It warned of shrinking demand for Bulgarian exports, decreased FDI, and high levels of private external debt. It questioned Bulgaria's optimistic growth forecasts and warned that spending would likely need to be reigned in to achieve targeted budget surpluses. Nevertheless, it noted that public finances are in good shape and the balance sheets of the central bank and government are strong.

¶7. (C) Comment: In this election year, the ruling Socialists are unlikely to agree to any deal with the IMF no matter how needed it might become. Since taking office in 2005, this government has pursued a highly "unsocialist" fiscal policy featuring some of the highest budget surpluses

in Europe and the introduction of low flat corporate and income tax rates. These policies haven't always been popular with the party's base, but they allowed Bulgaria to attract high levels of foreign investment while avoiding the financial difficulties experienced elsewhere in East Europe and the Baltics. This is a source of pride for this government and will be a key theme in the Socialist Party's election platform. An IMF agreement, even a precautionary one, would deal a blow to that strategy and will be avoided at all cost.

McEldowney